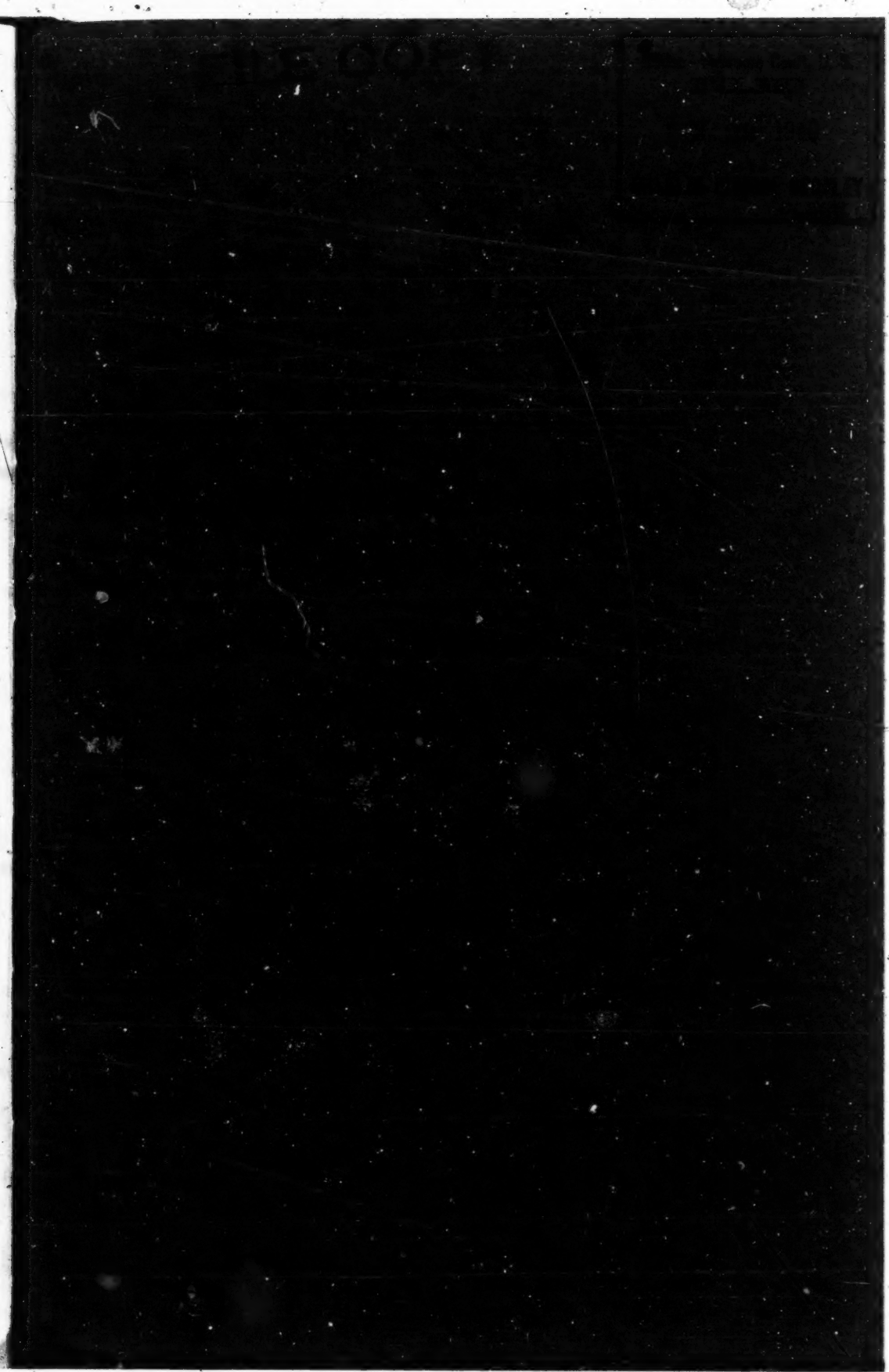

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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 55

DONALD S. McCLAIN, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 19–21) is unreported. The opinion of the Circuit Court of Appeals (R. 29–31) is reported in 110 F. (2d) 878.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 23, 1940 (R. 31). The petition for a writ of certiorari was filed April 15, 1940, and was granted May 20, 1940 (R. 34). The jurisdiction of this Court rests upon Section 240 (a) of the

Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer held bonds of a water improvement district, a political subdivision of the State of Texas. The district became unable to pay the principal and interest on its bonds and as a condition to its obtaining a loan so that it might continue its operations the bondholders agreed to surrender their bonds and accept 49.9% of their face value in satisfaction of them.

The question presented is whether the deduction of the resulting loss is subject to the limitations upon capital losses contained in Section 117 (d) of the Revenue Act of 1934. The answer to this question in turn depends upon whether there was a "retirement" of the bonds within the meaning of Section 117 (f).

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and regulations involved will be found in the Appendix, *infra*, pp. 38–41.

STATEMENT

The facts as stipulated (R. 14–19) and as found by the Board of Tax Appeals in its memorandum opinion (R. 19–21) are substantially as follows:

The taxpayer is a resident of Atlanta, Georgia (R. 14). In 1918 the taxpayer received as a gift from his father bonds of the Cameron County Water Improvement District Number Two, Cam-

eron County, Texas, a political subdivision of the State of Texas. The bonds had a par value of $15,000, and their value at the time of the gift was $15,000 (R. 14–15, 20).

The bonds were held for profit by the taxpayer but not in connection with his trade or business (R. 17).

In 1935 the District, being unable to pay the interest or principal of its bonds, had sought the benefits of the Municipal Bankruptcy Act, but the Act was declared unconstitutional by this Court. Thereupon, the District made application to the Reconstruction Finance Corporation for a refunding loan which the Reconstruction Finance Corporation granted in an amount sufficient to enable the District to pay 49.9¢ per dollar on the principal of the bonds held by the taxpayer and others, the payment to be made from the proceeds of the loan obtained by the District (R. 15, 20).

At the time of the loan, conditions had become very bad in Texas; landowners in the state were unable to pay their taxes, and the District was in default on both the principal and interest of the bonds. The District sought a loan of $300,000, but the Reconstruction Finance Corporation, on January 6, 1935, adopted a resolution authorizing a loan of only $264,500, to be secured by the assets of the District. It had determined after an appraisal that 49.9¢ on the dollar of principal was the maximum amount which the District could pay

in view of its current liabilities and charges (R. 15–16).

In authorizing the loan the Reconstruction Finance Corporation imposed the following conditions (R. 16–17):

> *Deposit of old securities.*—The holders of Old Securities who join in this plan of refinancing shall deposit the same with one or more committees, depositaries, or other responsible representatives satisfactory to them, which shall consent to the plan of refinancing contemplated by this resolution (hereinafter referred to as "Owners' Agents"), or shall otherwise give this Corporation satisfactory assurances that the Old Securities held by them will be subjected to such plan, in which latter case they are hereinafter referred to as "consenting owners." Old Securities deposited with Owners' Agents or held by consenting owners are hereinafter referred to as "Deposited Securities." Each Owners' Agent shall be duly authorized to receive all moneys payable to the holders of Old Securities deposited with it, to surrender the Deposited Securities and do all other acts and things necessary to enable the District to effect a reduction in its indebtedness to the extent and in the manner contemplated by this resolution.
>
> No loan shall be made hereunder (a) unless all of the Old Securities shall be thus deposited or (b) unless the Division Chief

> shall deem that such a large proportion of such securities has been deposited as will satisfactorily accomplish the purposes of this Corporation in authorizing this loan. In this latter event, as hereinafter more fully provided, lesser amounts may be payable on the Deposited Securities than in case all of the Old Securities are deposited.

The taxpayer consented to the plan of refinancing, forwarded his bonds to a bank in Texas, and upon the receipt of 49.9¢ on the dollar the bonds were delivered over to the bank as agent for the District to be cancelled (R. 17, 20).

It was the understanding of the taxpayer and all other bondholders thus surrendering their bonds that the amount of 49.9¢ on the dollar so received on account of the principal was the final and the only amount which they would receive on the bonds, although there was no writing to evidence this nor any agreement between the District and the bondholders to that effect (R. 17–18).

During 1935 the taxpayer wrote off his books as uncollectible the difference between $15,000, the value of the bonds on the date of their gift to him, and the amount received from the District, $7,476.75. In his return for 1935 he claimed a deduction of $7,523.25 as a bad debt (R. 18, 20).

The Commissioner determined that the transaction constituted a "retirement" of the bonds within the meaning of Section 117 (f), disallowed the de-

duction for a bad debt, and limited a deduction for a loss under Section 117 to $2,000.[1] On the basis of this and another adjustment not here involved he determined a deficiency of $1,034.25 (R. 8–12, 18, 19).

The Board of Tax Appeals sustained the Commissioner's determination and the Circuit Court of Appeals affirmed the Board's decision.

SUMMARY OF ARGUMENT

The narrow question involved in this case is whether the cash received by the taxpayer, upon the surrender at the invitation of the debtor, of his water improvement district bonds in consideration of the receipt of 49.9% of their face value was an amount received "upon retirement" of the obligations within the meaning of Section 117 (f) of the Revenue Act of 1934. If it was, Section 117 (f) requires that the amount be treated as having been received in exchange for the bonds, with

[1] It is not entirely clear whether or not the taxpayer had other capital losses which had already been allowed to the extent of his capital gains plus $2,000 or whether this was his only loss. The deficiency letter shows a disallowance of the total amount of $7,523.25 (R. 9) but also states that the $2,000 amount has already been allowed (R. 11). The stipulation (R. 18) and the Board's memorandum opinion (R. 20) indicate that he had no other capital losses and that $2,000 of the $7,523.25 loss was allowed. We have accepted the facts as stated in the stipulation and the Board's memorandum opinion, but in any event the parties have agreed that the deficiency was correctly determined if the loss is to be treated as a capital loss.

the consequence that the loss is a capital loss which may be deducted only in accordance with the limitations of Section 117 (a) and 117 (d).

The provisions of Section 117 (f) must necessarily be construed in the light of the Congressional purpose to stabilize the revenue by limiting the extent to which capital losses might be used to offset ordinary income. Congress sought to accomplish this purpose in two ways: (1), by changing the method of dealing with capital gains and losses, and (2), by expanding the operation of the capital gain and loss provisions to include transactions which were not strictly sales or exchanges of capital assets.

Section 117 (f) provides in substance that for the purpose of the income tax title amounts received by the holder upon the "retirement" of bonds or similar evidences of indebtedness issued by corporations, Governments, or political subdivisions, if such obligations constitute capital assets, shall be considered as amounts received in exchange therefor.

The word "retirement" must be taken to have been used in its ordinary sense in Section 117 (f). The verb "retire" has been defined as meaning "to withdraw from circulation, to take up and pay." There was a retirement of the bonds in this case, since they were taken up and paid and withdrawn from circulation when the taxpayer agreed to accept and did accept less than their face value in exchange for them.

The word "retirement" is a broader term than "redemption," which has been defined as meaning the payment of an obligation according to its terms, and the legislative history shows that the Congressional choice of the word "retirement" rather than the word "redemption" was deliberate. Hence the statute cannot be said to apply only to cases where bonds are redeemed in accordance with their terms either at maturity or pursuant to an authorized call prior to maturity.

Nor can the application of the statute be held to depend upon whether or not the retirement of the obligations was a voluntary or involuntary act on the part of the debtor.

The language of the statute suggests no such limitation and the purpose of Congress would not be served if the statute were so confined. The statute should be construed as applying to all situations where there is a surrender of the obligations to the debtor or some one standing in the position of the debtor for cash, whether in pursuance of the original contract or otherwise. From the bondholder's standpoint, all of such transactions have the practical consequences of a sale or exchange, and Congress undoubtedly meant to bring all of them under Section 117 (f).

This conclusion is fortified by the fact that when Congress enacted Section 23 (k) (2) of the Revenue Act of 1938, it brought within the operation of the gain and loss provisions a third class of cases,

namely, situations where the obligations are retained but have become totally worthless. It must have considered that a loss such as the one here involved already came under Section 117 (f), which remained unchanged in the Revenue Act of 1938.

The fact that under earlier statutes a loss such as the one here involved might have been deducted as a bad debt or that, but for Section 117 (f), it might be deducted as a bad debt under Section 23 (k) is immaterial. The bad debt provisions are general provisions relating to all classes of bad debts, whereas Section 117 (f) relates specifically to a retirement of bonds. A specific provision prevails over a general provision which might otherwise apply, and if this case comes under Section 117 (f), Section 23 (k) has no application.

ARGUMENT

THE TAXPAYER'S SURRENDER OF HIS BONDS FOR CASH CONSTITUTED A RETIREMENT OF THE OBLIGATIONS WITHIN THE MEANING OF SECTION 117 (f) AND THE LOSS THEREBY SUSTAINED WAS A CAPITAL LOSS

A. *Introductory*

The narrow question involved in this case is whether the cash received by the taxpayer upon the surrender, at the invitation of the debtor, of his water improvement district bonds in consideration of the receipt of 49.9% of their face value was an amount received "upon retirement" of the obligations within the meaning of Section 117 (f) of the

Revenue Act of 1934. If it was, Section 117 (f) requires that the amount be treated as having been received in exchange for the bonds, and his loss is regarded as a capital loss, which under Section 117 (a) may be taken into account only to the extent of 30% since the bonds had been held for more than ten years, and which under Section 117 (d) may, with any other capital losses, be deducted only to the extent of his capital gains plus $2,000. If it was not such a retirement, the Government concedes that the difference between the basis and the amount received may be deducted as a bad debt under Section 23 (k).

Before dealing with the precise question here involved, however, it will be helpful to consider the scope and purpose of Section 117 as a whole and the historical background of that section, which was enacted for the first time in 1934.

Section 117 represented a new and different method of dealing with gains and losses arising from the sale or exchange of capital assets. It not only brought within the scope of the operation of the capital gain and loss provisions transactions which had not theretofore been treated as sales or exchanges of capital assets but changed fundamentally the method of dealing with all capital gains and losses. One of the purposes of these changes was, as we shall subsequently point out, that of stabilizing the revenue, an objective toward which Congress had been working over a period of years.

The first statute that dealt comprehensively with capital gains and losses was the Revenue Act of 1924. Section 206 of the Revenue Act of 1921, c. 136, 42 Stat. 227, however, had contained special provisions with reference to capital net gains (defined as meaning the excess of capital gains over capital losses and capital deductions) and had provided that a taxpayer might elect to be taxed on his capital net gains at 12½% instead of at the ordinary normal and surtax rates, provided that in no case should the total tax be less than the 12½% of the total net income. The provision applied only to gains arising from "a sale or exchange of capital assets" which were defined generally as meaning property acquired and held for profit or for investment for more than two years. The purpose of this provision was to increase the revenue by encouraging the sale of assets held for a period of years which might otherwise remain unsold on account of the fear of the imposition of a prohibitive tax. See *Burnet* v. *Harmel,* 287 U. S. 103; H. Rep. No. 350, 67th Cong., 1st Sess., p. 10; S. Rep. No. 275, 67th Cong., 1st Sess., p. 12, H. Rep. No. 486, 67th Cong., 1st Sess., p. 20. No special treatment for capital losses was provided for in this statute

Under Section 208 of the Revenue Act of 1924, c. 234, 43 Stat. 253, a taxpayer who had sustained a capital net gain was again given an election to have the tax thereon computed at the 12½% rate instead of at the ordinary rates, and the limitation

on the amount of the tax that had existed under the earlier statute was eliminated. At the same time special treatment was accorded to capital net losses. Section 208 (c) had the effect of making the taxpayer pay the greater of the following taxes: (1) The tax computed by allowing the capital net loss as an ordinary deduction, and (2) the tax determined by allowing 12½% of the capital net loss to be deducted from the tax computed on the ordinary net income without the allowance of such a deduction. The purpose of these provisions was stated to be that of equalizing the treatment accorded to capital net losses and capital net gains (H. Rep. No. 179, 68th Cong., 1st Sess., pp. 19–20) but it obviously had the effect of limiting the extent to which a taxpayer could reduce the tax on his ordinary income by making use of capital losses. See *United States* v. *Pleasants,* 305 U. S. 357, 360.

Section 208 of the Revenue Act of 1926, c. 27, 44 Stat. 9, and Section 101 of the Revenue Act of 1928, c. 852, 42 Stat. 791, made few changes in the capital net gain and capital net loss provisions of the Revenue Act of 1924.[2]

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[2] They did, however, enlarge the definition of the term "capital assets" by providing that in certain cases where the taxpayer had acquired the property in a nontaxable exchange or as the result of a transaction which required him to use the transferor's base in measuring gain or loss the period that the exchanged property had been held or that the transferor had held the property was to be added in determining whether the two-year requirement was satisfied.

Section 101 of the Revenue Act of 1932, c. 209, 47 Stat. 169, did not make any substantial changes in the treatment accorded to capital net gains and capital net losses, but Section 23 (r) imposed certain limitations on the deduction of losses from the sale or exchange of stocks and bonds which were not capital assets as defined in Section 101. Section 23 (r) provided that except in the case of banks and dealers in securities losses from such sales should be deducted only to the extent of capital gains from similar sales, though under certain limitations, however, losses of that character disallowed in one taxable year could be applied against gains from the sale of noncapital assets in the succeeding year. The purpose of Section 23 (r) was that of protecting the revenue by preventing the practice of using losses on security transactions to reduce taxes and of preventing speculative losses from wiping out ordinary income. H. Rep. No. 708, 72d Cong., 1st Sess., pp. 12–14; S. Rep. No. 665, 72d Cong., 1st Sess., pp. 10, 17–18; H. Rep. No. 1492, 72d Cong., 1st Sess., p. 12. The provision was made more comprehensive by Section 23 (s) which provided that gains or losses from short sales of stocks and bonds or from privileges or options to buy or sell securities

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These were merely changes designed to correlate different sections of the statute (see H. Rep. No. 1, 69th Cong., 1st Sess., pp. 6–7) but insofar as they applied to capital losses they imposed further limitations on the reduction of taxes by means of losses on the sale or exchange of capital assets.

should be treated as gains or losses from the sale of such securities.

There were other provisions enacted during the period 1921–1934 which were also designed to stabilize the revenue by limiting the impact of capital gains and losses upon ordinary income. For instance, Section 214 (a) (5) of the Revenue Acts of 1921, 1924, and 1926 had prohibited the deduction of losses on the sale of securities where substantially identical securities were purchased within thirty days. See also Section 118 of the Revenue Acts of 1928, 1932, and 1934.

In enacting the Revenue Act of 1934, Congress showed unmistakable evidence of its desire to lessen further the effect upon the revenue of the recognition of capital losses. For instance, Section 24 (a) (6) prohibited the deduction of losses from sales and exchanges of property directly or indirectly between members of a family and, except in the case of a liquidation, between an individual and a corporation in which he and his family owned more than 50% of the stock. Section 23 (g) provided that losses from wagering transactions could be deducted only to the extent of gains from such transactions.

But more important innovations were made in Section 117. That section does not, as do previous statutes, provide for a separate computation of the tax on capital gains and losses, but rather imposes limitations on the extent to which such gains and

losses can be taken into account in computing net income. Section 117 (a), which is applicable only to individuals, provides that only certain percentages of the capital gains shall be taken into account depending upon the length of time that the asset has been held. The percentage ranges from 100% where the asset had been held for not more than one year to 30% where the asset has been held for more than ten years.[3] Section 117 (d), which is made applicable to corporations as well as individuals, provides that capital losses shall be deducted only to the extent of capital gains plus $2,000. Under previous statutes, the capital gain and loss provisions had not applied to corporations. One of the purposes of these limitations, particularly of Section 117 (d), was that of achieving more stability in the revenues by preventing capital losses from being offset against ordinary income. See H. Rep. No. 704, 73d Cong., 2d Sess., pp. 9–10, 30–32, and the statement on the Senate Floor by Chairman Harrison of the Senate Finance Committee (Cong. Record, Vol. 78, Part 6, p. 5846).

As a part of the same general purpose Congress

[3] Section 117 (c) lays down certain rules for determining how long an asset has been held for the purpose of applying this section, which rules are taken from the definition of capital assets in previous laws which had defined the term as meaning property held by the taxpayer for more than two years (see Section 101 of the Revenue Act of 1932). In this statute, the term "capital assets" is defined simply as meaning property held by the taxpayer with certain limitations. See Section 117 (b).

sought to bring certain transactions which might not normally be regarded as constituting sales or exchanges within the operation of the statute. To that end it provided in Section 117 (f) that amounts received upon the retirement of bonds or other evidences of indebtedness issued by a corporation or a Government, or one of its subdivisions, should be treated as having been received in exchange therefor.

The enactment of this provision followed the decisions of the Board of Tax Appeals in *Watson* v. *Commissioner,* 27 B. T. A. 463 (decided in December, 1932, and *Braun* v. *Commissioner,* 29 B. T. A. 1161 (decided in February 1934),[4] holding that payments of the amount specified in a bond either at maturity or pursuant to an authorized call prior to maturity did not constitute a sale or exchange. This Court subsequently reached the same conclusion in *Fairbanks* v. *United States,* 306 U. S. 436, but that case had not then been decided either by this Court or the lower courts.

The broadening of the scope of Section 117 was to be carried still further under the Revenue Act of 1938, by provisions hereinafter referred to, but so far as pertinent here, the vital step was taken by the enactment of Section 117 (f) of the Revenue Act of 1934 (Appendix, *infra,* p. 40). The language of that provision must necessarily be con-

[4] These decisions overruled the decision of the Board in *Werner* v. *Commissioner,* 15 B. T. A. 482, which had held to the contrary.

strued in the light of this history of the earlier statutes and of a recognition that the purpose of Congress in enacting it was that of stabilizing the revenue and of expanding the operation of the capital gain and loss provisions.

B. Section 117 (f) covers all transactions whereby bonds or other evidences of indebtedness of a corporation or of a government are surrendered for cash and the debt is thereby extinguished

Section 117 (f) provides as follows:

> (f) *Retirement of bonds, etc.*—For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

The above-quoted provision is very broad. It applies to all bonds, debentures, notes, certificates, or other evidences of indebtedness issued by a corporation or by a government or political subdivision thereof with interest coupons or in registered form, and provides without exception that all amounts received by the holder of such obligations upon their retirement shall be considered as received in exchange therefor. A transaction by which a creditor at the invitation of his debtor surrenders his bonds for an amount less than their

face value would clearly seem to be the type of transaction which Congress would have wished to reach if its purpose was to bring within the operation of capital gain and loss provisions dispositions of bonds for cash which were not sales or exchanges, but which had a similar effect. It must indeed have had precisely this type of transaction in mind, for the year 1934 was a year of financial difficulties when many readjustments of debt were taking place, and to achieve its declared purpose of stabilizing the revenues, it was necessary to legislate with reference to those adjustments.

The taxpayer's whole argument that Section 117 (f) does not apply to his case is based upon the construction which he places upon the word "retirement." He argues that a "retirement" of securities means the payment of an obligation in full at maturity and does not have any reference to the compromising of corporate obligations or an incomplete or partial payment thereof. He argues further that Congress intended only to meet cases like the *Watson case, supra,* where it had been held that a loss upon the redemption of bonds was not a capital loss.

We submit that the court below properly construed the word "retirement" as being applicable to a situation where securities at the invitation of the debtor are taken up for an amount less than their face value and withdrawn from circulation. See also *Corbin* v. *Commissioner,* 39 B. T. A. 1163.

Neither the word "retirement," which means merely the "act of retiring" (Webster's New International Dictionary), nor the verb "retire" are words of art. The latter is defined in Webster's New International Dictionary (1939 Ed.), p. 2128, as meaning, among other things, "To withdraw from circulation, or from the market; to take up or pay; as, to *retire* bonds; to *retire* a note." The Century Dictionary and Cyclopedia (Revised Ed.), Vol. VIII, p. 5123, defines "retire" as meaning "To recover; redeem; regain by the payment of a sum of money; * * *." In the absence of any evidence that retirement was used in a peculiar sense in Section 117 (f) it must be given its ordinary meaning (*Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552; *Woolford Realty Co.* v. *Rose,* 286 U. S. 319; *Old Colony Co.* v. *Commissioner,* 301 U. S. 379), and there was a retirement of the bonds in this case, since they were taken up and paid and withdrawn from circulation when the taxpayer agreed to accept and did accept less than their face value in exchange therefor.

The taxpayer in substance argues that the word "retire" has the same meaning as "redeem." But that is not the case. The word "redeem" has been defined as meaning the "payment of an obligation according to its terms." *United States* v. *Fairbanks,* 95 F. (2d) 794, 796 (C. C. A. 9th), affirmed, 306 U. S. 436; *Watson* v. *Commissioner,* 27 B. T. A. 463; *Braun* v. *Commissioner,* 29 B. T. A. 1161. See

also *Felin* v. *Kyle*, 102 F. (2d) 349 (C. C. A. 3d). If the word "redemption" had been used in the statute there might have been some basis for the taxpayer's argument that Section 117 (f) does not apply. But the statute employs the term "retirement" and not the term "redemption"; and while a retirement undoubtedly includes a redemption, it is a broader term and may apply to transactions by which bonds or other evidences of debt are surrendered for cash and cancelled, even though they are not discharged in accordance with the terms of the original contract but in accordance with an independent agreement.[5] In *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, upholding the validity of a regulation which provided that if a corporation purchases and retires any of its bonds at a price less than the issuing price, it realizes a gain, the word "retire" was used in the sense of a cancellation or withdrawal from circulation. See also Section 23 (r) (1) of the Revenue Act of 1932 providing that losses on the sale or exchange of non-capital assets are deductible only to the extent of gains derived from similar transactions, including

[5] That the two words are not the same is suggested by the fact that both are used under the reorganization provisions of the Bankruptcy Act in such manner as to indicate that Congress believed them to have different contents. See Act of June 22, 1938, c. 575, 52 Stat. 840, 895–897, amending Section 216 (12) (b) of the Bankruptcy Act of July 1, 1898, c. 541, 30 Stat. 544, as amended.

gains derived by the taxpayer from the retirement of his own obligations.

If, as the taxpayer contends, the purpose of Congress had been merely to reach situations such as the one involved in the *Watson* case, where there was a discharge of the obligation in accordance with the terms of the contract, it would no doubt have used the word "redemption," which would fit such a case. In choosing a broader and less restricted term it must have had in mind other transactions. This conclusion is strengthened by the fact that the legislative history of the provision shows that the choice of the word was deliberate. The Committee on Federal Taxation of the American Bar Association had recommended to the Committee on Ways and Means of the House that the existing law be amended to make it clear that the definition of capital gains and losses include gains and losses arising from the redemption of capital assets. House Hearings before the Committee on Ways and Means on Revenue Revision, 1934, 73d Cong., 2d Sess., pp. 190–191. But Congress chose another word.

The decision of the Circuit Court of Appeals for the Second Circuit in the case of *Thomson* v. *Commissioner*, 108 F. (2d) 642, now pending before this Court, No. 58, October Term, 1940, upon which the petitioner relies, did not directly hold that Section 117 (f) applies only to a redemption of securi-

ties, though the court unduly restricted the meaning of the word "retirement" and held that there was not a retirement of the debentures there involved, but an "extinguishment" where they were surrendered for a small sum in the course of receivership. The court there apparently drew a distinction between voluntary and involuntary transactions and held that a retirement referred only to a transaction which was voluntary on the part of the debtor and that in the case of an involuntary transaction there was merely an extinguishment of the debt which gave rise to a bad debt deduction. It also apparently attached some importance to the fact that only a small proportion of the face value of the bonds was received upon their surrender.

In our briefs in *Commissioner* v. *Hammel,* No. 49, October Term, 1940, and *Electro-Chemical Engraving Co., Inc.* v. *Commissioner,* No. 62, October Term, 1940, the Government is arguing that Section 117 applies to losses sustained through the foreclosure sale of property, even though the transaction is involuntary. If that is the proper construction of the general provisions of Section 117, there is no reason to suppose that Section 117 (f) is more limited. But even if the Court should hold that a sale implies a voluntary transaction in those cases, such conclusion would afford no justification for the view that whether or not a bondholder has had his bonds retired and thus incurred a capital

loss depends upon whether or not the transaction was voluntary or involuntary. That such a distinction is artificial is illustrated by the facts in this case, where the water improvement district and the bondholders had no choice except the course which they pursued. The district was insolvent; it could not legally declare itself a bankrupt; it had no means of paying its obligations; it was obliged to cons[illegible] to the terms which the Reconstruction Finance [illegible]poration imposed in granting the loan, and the bondholders were obliged to accept the district's terms, which called for a surrender of the bonds and the payment of 49.9% of their face value. Yet, technically perhaps, the transaction was a voluntary one and, if so, would, according to the reasoning of the court in the *Thomson* case, come under Section 117 (f), whereas in the *Thomson* case, where the transaction was technically involuntary, the provision would not apply. Such a distinction between the two cases seems artificial and unreal since the taxpayer-bondholder has sustained precisely the same kind of loss in the two cases. Moreover, the legislative history of the provision indicates that Congress had no such distinctions in mind.

There are three types of situations in which the taxpayer may realize a loss upon the evidences of indebtedness of a corporation or of a government, namely, (1) a disposition of the securities by a sale or exchange which involves a transaction with a

third person, (2) a surrender of the securities to the debtor or someone standing in the position of the debtor for cash, and (3) the securities becoming worthless, which does not involve any transaction with anyone. The first two of these situations, but not the third, could also give rise to a gain.

Under the statutes prior to 1934, only the first situation, namely, a disposition of the securities by a sale or exchange, was covered by the capital gain and loss provisions. In *Fairbanks* v. *United States*, 306 U. S. 436, this Court held that the payment and discharge of a bond in accordance with its terms, whether at maturity or pursuant to an authorized call prior to maturity, was not a sale or exchange. See also *Watson* v. *Commissioner*, 27 B. T. A. 463; *Felin* v. *Kyle*, 102 F. (2d) 349 (C. C. A. 3d). It was also held that a compromise with the maker of a promissory note for less than its full value was not a sale or exchange. *Hale* v. *Helvering*, 85 F. (2d) 819 (App. D. C.). Though that case did not involve corporate securities, presumably the same rule would apply in such a case. In other words, the only transaction which was regarded as constituting a sale or exchange was a transaction by which the bond or other evidence of indebtedness was transferred to a third person for a consideration. If was held that where the transaction involved the creditor and debtor only, there was merely a payment and discharge of the debt in whole or in part and not a sale or exchange. See

Felin v. *Kyle, supra; Bingham* v. *Commissioner,* 105 F. (2d) 971 (C. C. A. 2d); *Buell* v. *Commissioner,* 106 F. (2d) 398 (C. C. A. 10th). See also *Averill* v. *Commissioner,* 101 F. (2d) 644 (C. C. A. 1st), where the court recognized this distinction, but nevertheless held that a redemption of bonds should be regarded as a sale or exchange.

It is obvious that from the point of view of taxation there had never been any reason, apart from the controlling language of the statute, for treating differently the various types of losses which a taxpayer sustains on investments in corporate and governmental bonds or other evidences of indebtedness. The practical consequences to the bondholder are the same whether his loss is sustained (1) by selling the bonds to a third person, (2) by surrendering them for cash to his debtor, or some one standing in the debtor's position, whether in pursuance of the original contract or otherwise, or (3) by having them become worthless on his hands. The second situation, however, more closely resembles a sale than does the third, since in both cash is received and the securities are disposed of. In the third class the securities are retained, but their value is irretrievably gone so that they cannot be sold or otherwise disposed of.

It is our position that when Congress enacted Section 117 (f) it intended to cover all transactions coming within the second class, namely, all cases in which the taxpayer disposed of his securities for

cash otherwise than by a transaction with a third person. It is logical to assume that that was its intention because of the resemblance which these transactions bore to a sale or exchange and because of the language of the statute itself, which requires that "amounts received upon the retirement" of such obligations shall be treated as having been received in exchange therefor. In no case where the creditor surrenders his obligations to his debtor for cash is the obligation actually exchanged for the cash; rather the obligation is extinguished. See *United States* v. *Fairbanks, supra.* Hence, if Congress meant to treat one case of this type as an exchange, it undoubtedly meant to include all, regardless of whether the obligation was redeemed in accordance with its terms, as in the *Fairbanks* case, was surrendered in pursuance of an independent agreement with the debtor as here, or was surrendered in the course of a receivership or bankruptcy proceeding as in the *Thomson* case. The sole requirement was that there should be a retirement, that is, a cancellation, and that consideration should be received upon such a retirement.

This conclusion is strengthened by the fact that when Congress enacted the Revenue Act of 1938 it took care of the third class of cases, namely, cases where securities are retained but have become worthless. Section 23 (k) (2) of that Act provides that if securities (defined as including bonds, debentures, notes, certificates, or other evidences of

indebtedness issued by a private corporation or a government with interest coupons or in registered form) are ascertained to be worthless and charged off within the taxable year and are capital assets, the loss resulting therefrom shall, except in the case of a bank, be considered as a loss arising from an exchange or a sale.

Congress undoubtedly thought that by the enactment of this provision it had enacted the final provision necessary to achieve a uniform treatment of all losses arising from investments in corporate securities. In that connection it should be pointed out that amounts received by stockholders on the liquidation of corporations were already treated as being received from a sale or exchange of capital assets (see *White* v. *United States,* 305 U. S. 281, and *Helvering* v. *Weaver Co.,* 305 U. S. 293), and that in Section 23 (g) (2) of the Revenue Act of 1938 Congress took the final step with reference to losses on stock investments when it brought within the operation of capital gain and loss provisions losses sustained when stocks became worthless.

The taxpayer may argue that the transaction here involved is one which, if it had occurred in 1938, would fall under Section 23 (k) (2) of the Revenue Act of 1938 rather than under Section 117 (f) of that Act (which is identical with Section 117 (f) of the Revenue Act of 1934) and, hence, that in 1934 there was no provision which covered it. But Section 23 (k) (2), relating to

worthless bonds and similar evidences of indebtedness, and Section 23 (g) (2), relating to worthless stocks, both referred to situations where there was no disposition of the securities and nothing was or could be received from them—that is, to securities which become totally worthless. See *White* v. *United States,* 305 U. S. 281. The legislative history of those two sections supports that view. See H. Conference Rep. No. 2330, on the Revenue Bill of 1938, 75th Cong., 3d Sess., p. 35. See also Report of Subcommittee of the Committee on Ways and Means on a Proposed Revision of the Revenue Laws, 75th Cong., 3d Sess., pp. 44–46. The Treasury Department has consistently construed Section 23 (k) (2) as being applicable only to cases where the securities have become totally worthless. See Article 23 (k)–4 of Regulations 101, promulgated under the Revenue Act of 1938. The provision was not designed to cover a transaction in which bonds were surrendered in consideration of the receipt of cash, whether in a receivership as in the *Thomson* case or in the course of a refinancing as here. Those transactions were either covered by Section 117 (f) or were not covered by any provision,[6] which seems an unreasonable assumption. Congress must, therefore, have intended Section 117 (f) to apply to such cases.

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[6] Under the Revenue Act of 1938 no deduction may be claimed under Section 23 (k) (1) for bonds or similar evidences of indebtedness which are ascertained to be worthless in whole or in part. Such debts are expressly excluded from the operation of the general provisions relating to bad debts.

In *White* v. *United States*, 305 U. S. 281, 292, the Court considered the closely analogous situation where a stockholder receives a relatively negligible amount upon liquidation of his corporation. The Court pointed out that the resulting loss would be a capital loss subject to the limitations of Section 101 of the Revenue Act of 1928, notwithstanding the taxpayer's contention that had he received nothing at all upon liquidation he would have been entitled to much greater tax benefits through the deduction for worthless stock.[7] The possible harsh results that might flow from such apparent discrimination was not considered sufficient to depart from the plain language of the statute. The Court also pointed out that even though Section 23 (g) (2) of the subsequently enacted Revenue Act of 1938 provided that the loss upon worthless stock should be treated as a capital loss, the contrary result nevertheless continued for prior years. 305 U. S. at 292.

Similarly, there is a distinction under the Revenue Act of 1938 between transactions coming under Section 23 (k) (2) and those coming under Section 117 (f), though under that Act both are brought under the operation of the capital gain and loss provisions. Hence, under that statute the transaction here involved, and that involved in the *Thomson* case, would be treated as a loss from an exchange of capital assets by virtue of Section 117 (f) and not by virtue of Section 23 (k) (2).

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[7] A similar result was reached in *Echols* v. *Commissioner*, 61 F. (2d) 191 (C. C. A. 8th).

It follows that under Section 117 (f) of the Revenue Act of 1934, which is identical with Section 117 (f) of the Revenue Act of 1938, the amounts received by the taxpayer upon the surrender of his bonds for cash are to be regarded as having been received in exchange therefor and accordingly are subject to the limitations of Section 117 (d).

C. *A transaction coming under Section 117 (f) cannot be treated as giving rise to a bad-debt deduction under Section 23 (k) of the Revenue Act of 1934*

The taxpayer argues that bonds have always been regarded as debts and that when ascertained to be worthless in whole or in part and charged off have been deductible as bad debts. It is further claimed that amounts lost in a composition with an insolvent debtor have been permitted to be deducted as bad debts determined to be worthless in part. It is argued that since Section 23 (k) of the Revenue Act of 1934 is similar to the bad-debt provisions of the earlier statutes, it must likewise be construed as being applicable to such cases and that Section 117 (f) must be construed as applying only to a situation where bonds are called in and paid at par, where the loss has been treated as a loss and not a bad debt.

Section 23 (k) of the Revenue Act of 1934 (Appendix, *infra*, p. 38) provides for the deduction of debts ascertained to be worthless and charged off

during the taxable year and provides further that when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year as a deduction. The Government does not deny that bonds have been treated as debts within the meaning of similar bad-debt provisions of the previous revenue acts (*Pacific Nat. Bank* v. *Commissioner*, 91 F. (2d) 103 (C. C. A. 9th); *Commonwealth Commercial State Bank* v. *Lucas*, 41 F. (2d) 111 (App. D. C.); *Lebanon Nat. Bank* v. *Commissioner*, 76 F. (2d) 792 (C. C. A. 3d)). Moreover, the regulations promulgated under the Revenue Act of 1934, like those promulgated under previous statutes, provide that under certain conditions a deduction for a bad debt may be claimed with reference to bonds. Article 23 (k)–4 of Regulations 86 (Appendix, *infra*, p. 40) provides that where there is a foreclosure sale of property securing bonds of an insolvent corporation from which nothing is realized from the bondholder, the total basis is allowable as a debt. It further provides that where the bondholder ascertains that due to the financial condition of the debtor bonds he holds will not be paid at maturity, either in whole or in part, all or a part of their cost may be charged off and deducted as a bad debt. See also Article 23 (k)–1 of Regulations 86, which provides rules for deduction of bad debts generally, and which, under

proper circumstances, may be held to apply to bonds. These regulations are merely a restatement of regulations issued under earlier statutes (see Articles 191 and 194 of Regulations 77, promulgated under the Revenue Act of 1932).

Under earlier statutes similar to or identical with Section 23 (k) of the Revenue Act of 1934[8] and regulations substantially identical in all material respects with Article 23 (k)–4 of Regulations 86, it has been held that a bad-debt deduction might be claimed with respect to bonds which were ascertained to be worthless and charged off in whole or in part. *Montgomery* v. *United States*, 23 F. Supp. 130 (C. Cls.), certiorari denied, 307 U. S. 632; *Pacific Nat. Bank* v. *Commissioner, supra; Lebanon Nat. Bank* v. *Commissioner, supra; Huntting* v. *Commissioner*, 32 B. T. A. 495. See also *Santa Monica Mountain Park Co.* v. *United States*, 99 F. (2d) 450 (C. C. A. 9th);[9] *Securities Allied Corp.* v. *Commissioner*, 95 F. (2d) 384 (C. C. A. 2d), certiorari denied, 305 U. S. 617. It should be noted, however, that it was only under very unusual circumstances that a deduction was allowed with

[8] Section 23 (k) (Appendix, *infra*, p. 38) is identical with Section 23 (j) of the Revenue Act of 1932, but both differ from Section 23 (j) of the Revenue Act of 1928 which provided that when satisfied that a debt is recoverable only in part, the Commissioner might allow such debt to be charged off in part.

[9] A writ of certiorari was granted in this case (306 U. S. 624), but was dismissed by stipulation of counsel (306 U. S. 666).

respect to bonds claimed to be worthless in part. That was attributable in part to the discretion given to the Commissioner under the bad-debt provisions with respect to the allowance of deduction for debts claimed to be worthless in part (see Section 23 (j) of the Revenue Acts of 1928 and 1932; *United States* v. *Beckman*, 104 F. (2d) 260 (C. C. A. 3d), certiorari denied, *sub nom. Doty* v. *United States*, 308 U. S. 593) and in part to the fact that the regulations have always prohibited the allowance of a deduction on account of a fluctuation in the value of bonds or similar securities. *Securities Allied Corp.* v. *Commissioner, supra.* A special rule applied to banks which were required by state or federal authorities to charge off debts in part. See Article 191 of Treasury Regulations 77; *Citizens' Nat. Bank* v. *Commissioner*, 74 F. (2d) 604 (C. C. A. 4th), and it will be found that many of the cases in which deductions were allowed with respect to bonds claimed to be worthless in part involved banks.

In the case where the debt has been compromised because the debtor could not pay, the amount which could not be collected has been allowed as a bad debt. *Deeds* v. *Commissioner*, 47 F. (2d) 695 (C. C. A. 6th); *Commissioner* v. *National Bank of Commerce of San Antonio, Texas*, decided June 27, 1940 (C. C. A. 5th), not yet officially reported but may be found in 1940 C. C. H., Vol 4, ¶ 9550. See also *Commissioner* v. *Wilson*, 90 F. (2d) 788 (C. C. A. 7th); *Johnson, Drake & Piper, Inc.* v. *Helver-*

ing, 69 F. (2d) 151 (C. C. A. 8th), certiorari denied, 292 U. S. 650. In *Hale* v. *Helvering, supra,* where the debtor could pay, it was held that such a transaction did not constitute a capital loss but the court implied that it was not necessarily a bad debt. See also *Pacific Novelty Co.* v. *Commissioner,* 5 B. T. A. 1017.

But if it be conceded that the difference between the face value of the bonds and the amount received upon their surrender by the taxpayer might otherwise be deductible as a bad debt under Section 23 (k), the situation is changed by Section 117 (f). The latter provision deals specifically with the retirement of bonds, and under a well-established rule of construction a specific provision prevails over a general provision which might otherwise apply (*Missouri* v. *Ross,* 299 U. S. 72; *Hellmich* v. *Hellman,* 276 U. S. 233; *Ginsberg & Sons* v. *Popkin,* 285 U. S. 204; *United States* v. *Chase,* 135 U. S. 255). Therefore, Section 117 (f) controls if there was a retirement of the bonds, even though Section 23 (k) might otherwise be applicable. And the regulations interpreting Section 23 (k) cannot bring within the operation of the general provisions of that section the specific transactions which are governed by Section 117 (f).

Moreover, Section 117 (f) is a provision of limited application and Section 23 (k) and the regulations relating to bad debts still govern certain types of losses with respect to bonds. Section

117 (f) is a specific provision designed to meet one type of loss arising from investments in bonds, debentures, and other evidences of indebtedness issued by corporations and governments, namely, as loss on their retirement. It does not apply to similar obligations of individuals. In *Thomas* v. *Perkins*, 108 F. (2d) 87 (C. C. A. 5th), the court held that it did not apply to certificates of indebtedness issued by a creditor's committee, which took over the assets of a corporation, a partnership, and certain individuals. The same court recently has held in *Commissioner* v. *National Bank of Commerce of San Antonio, Texas, supra*, that the bad debt provisions of the Revenue Act of 1934, rather than the capital loss provisions, were applicable to a situation where the taxpayer held notes of an estate and accepted in settlement property which was worth less than the face value of the notes.[10]

But Section 117 (f) applies where any amounts are received in retirement of corporate or government obligations [11] which are capital assets. There are thus brought within the ambit of the capital

[10] Section 117 (f) also does not apply to all investments in corporate or governmental bonds or other evidences of indebtedness. It does not, for example, apply to obligations which are not capital assets as defined in Section 117 (b).

[11] See I. T. 3121, 1937–2 Cum. Bull. 138. This is one of the few Bureau rulings with reference to Section 117 (f). See also I. T. 2986, XV–1 Cum. Bull. 136 (1936). There are no regulations construing the provision.

loss provisions transactions which under previous statutes had been treated as giving rise to a deduction for a bad debt. There is nothing in Section 117 (f) itself or in its legislative history that supports the taxpayer's view that it was intended to apply only to transactions which had hitherto been held to give rise to a loss rather than a bad debt, as in the *Watson* case, *supra,* where bonds purchased at a premium were retired at a loss. It is true that Section 23 (k) (Appendix, *infra,* p. 38) was the same as Section 23 (j) of the Revenue Act of 1932. But Section 23 (e) of the Revenue Act of 1934, the general provision regarding losses, is also the same as Section 23 (e) of the Revenue Act of 1932. There is consequently no basis for the assumption that Congress meant to exclude certain losses from Section 23 (e) and to bring them under Section 117 but that it meant to have Section 23 (k) apply to all cases to which it formerly applied. Section 117 (f), moreover, was not enacted with specific reference to losses but applies to gains as well.

Inasmuch as the bonds here involved were retired and amounts were received upon their retirement, those amounts are to be treated as having been received in exchange therefor under Section 117 (f) and the difference between such amounts and the basis is a capital loss, subject to limitations of Section 117 (d), though but for those provisions the difference might be deductible as a bad debt.

CONCLUSION

The decision of the Circuit Court of Appeals should be affirmed.

Respectfully submitted.

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APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(j) *Capital losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117 (d).

(k) *Bad debts.*—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

* * * * *

(U. S. C., Title 26, Sec. 23.)

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *General rule.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.

(b) *Definition of capital assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * *

(d) *Limitation on capital losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. If a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of whose business is the receipt of deposits, sells any bond, debenture, note, or certificate or other evidence of indebtedness issued by any corporation (including one issued by a government or political subdivision thereof), with interest coupons or in registered form, any loss resulting from such sale (except such portion of the loss as does not exceed the amount, if any, by which the adjusted basis of such instrument exceeds the par or face value thereof) shall not be sub-

ject to the foregoing limitation and shall not be included in determining the applicability of such limitation to other losses.

* * * * *

(f) *Retirement of bonds, etc.*—For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor. (U. S. C., Title 26, Sec. 101.)

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 23 (k)–4. *Worthless bonds and similar obligations.*—Bonds, if ascertained to be worthless, may be treated as bad debts to the amount actually paid for them. Bonds of an insolvent corporation secured only by a mortgage from which on foreclosure nothing is realized for the bondholders are regarded as ascertained to be worthless not later than the year of the foreclosure sale, and no deduction for a bad debt is allowable in computing a bondholder's income for a subsequent year.

A taxpayer (other than a dealer in securities) possessing debts evidenced by bonds or other similar obligations can not deduct from gross income any amount merely on account of market fluctuation. If a taxpayer ascertains, however, that due, for instance, to the financial condition of the debtor, or conditions other than market fluctuation, he will recover upon maturity none or only a part

of the debt evidenced by the bonds or other similar obligations and so demonstrates to the satisfaction of the Commissioner, he may deduct in computing net income the uncollectible part of the debt evidenced by the bonds or other similar obligations.

* * * * * *

ART. 117–4. *Application of section 117 generally.*—Section 117 applies only to gains and losses upon the sale or exchange of capital assets and, therefore, has no application to loss of useful value upon the permanent abandonment of the use of property (see article 23 (e)–3), or loss sustained as the result of corporate stock or debts becoming worthless.

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